CFA INSTITUTE | Centre for Financial Market Integrity

21 January 2009

Mr. Gavin Francis
Director of Capital Markets,
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: Comment Letter on the IASB Exposure Draft on Embedded Derivatives: *Proposed amendments to IFRIC 9 and IAS 39*

Dear Mr. Francis,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB Exposure Draft on Embedded Derivatives: *Proposed amendments to IFRIC 9 and IAS 39* (*ED*). The changes relate to IFRIC 9 (*(Reassessment of Embedded Derivatives) and IAS 39.*

The CFA Institute Centre represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 86,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Charlottesville New York Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

EXECUTIVE SUMMARY

Included in the appendix is a primer on the issues related to embedded derivatives accounting and why it matters in the credit crisis.

Background and Summary of proposals

The IASB has issued an exposure draft of a proposed amendment to IFRIC 9 and IAS 39 to counteract unintended consequences of the Board's amendments of IAS 39 and IFRS 7 in October, 2008.[3] Those amendments permit firms to reclassify certain financial assets out of the "fair value through profit or loss" category, resulting in an amortised cost treatment for the assets. As currently written, IFRIC 9 can be interpreted as disallowing the reassessment of an embedded derivative when a hybrid financial asset is reclassified out of the fair value through profit or loss category. Under such an interpretation, an embedded derivative would lose fair value reporting treatment along with the host instrument. We understand the Board did not intend that result in its October amendment.

The proposed amendments to IFRIC 9 and IAS 39 would require entities to reassess embedded derivatives to be separated from a host contract when a host contract is reclassified from the fair value through gain or loss category. Under the proposed amendments, the hybrid financial asset is required to remain in the fair value through gain or loss category if a reliable fair value cannot be determined for the embedded derivative, using characteristics in place at the onset of the contract.

The ED

- Clarifies that an entity must assess whether an embedded derivative is required to be separated from a host contract when the entity reclassifies a hybrid (combined) financial asset out of the fair value through profit or loss category.
- Requires the assessment to be made on the basis of the circumstances that existed when the entity first became a party to the contract.
- Proposes that if the fair value of an embedded derivative that would have to be separated cannot be reliably measured, the entire hybrid (combined) financial instrument must remain in the fair value through profit or loss category.

Additional Background from the Proposal:

1. IFRIC 9 does not allow the reassessment of an embedded derivative unless the contract terms change in a way that would significantly affect cash flows needed, leading some to interpret that embedded derivatives in a hybrid financial asset cannot be separated from a host contract when it is reclassified from the fair value through profit or loss category. Entities did not have the ability to reclassify financial assets out of the fair value through profit or loss category when IFRIC 9 was issued in 2006.

2. The October, 2008 issuance of *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7) unintentionally gave entities the ability to reclassify certain hybrid financial assets out of the fair value through profit or loss category without separately accounting for the embedded derivatives. Ideally, this

[3] Reclassification of Financial Assets (Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures)

proposal's invocation of a reassessment requirement in the event of a reclassification should have been included in the October amendment.

3. The amendments in the exposure draft would require an entity to reassess an embedded derivative when a hybrid financial asset is reclassified out of the fair value through profit or loss category and require the hybrid financial asset to remain in the fair value through profit or loss category if the entity can not determine, using the circumstances that existed at the outset of the contract, a reliable fair value for the embedded derivative.

Recommendations

- We urge the Board to address financial instrument accounting in its entirety rather than having an ad-hoc patchwork of changes and to resist pressures for a 'race to the bottom' based on arguments of seeking to level the playing field with US GAAP.
- We support the general thrust of the amendments, as they uphold the principle that the recognition and measurement of both embedded and standalone derivatives should be done on a fair value basis.
- On the amendments in the ED, we concur with the approach of not allowing the reclassification of hybrid instruments when it is difficult to determine the value of embedded derivatives. However, we believe that the reassessment for separation when reclassifying hybrid instruments should be made based on the circumstances at the date of reclassification rather than those at the initiation of the contract.

GENERAL COMMENTS

We support the general thrust of the amendments as they uphold the principle that the recognition and measurement of all derivatives should be based on a fair value basis. As has been acknowledged in paragraph BC4, IFRIC 9 had not discussed the circumstances that would necessitate reclassification out of the fair value through profit and loss category.

These amendments clarify the interpretation difficulties that arose due to the amendments enacted in October 2008 to IAS 39. The Committee of European Securities Regulators (CESR) report, dated 7th January 2009, partially illustrates the inconsistencies in the adoption and implementation of the reclassification amendments that are observable across a cross section of financial institutions. Clearly these reclassifications have resulted in a deterioration of the overall financial reporting quality as they reduced the comparability of financial statements and widened the opportunities for accounting based on managerial intent rather than the underlying economics. Therein, the amendments contained in the ED provide some degree of 'damage control' and are therefore welcome.

Apart from the merits of ensuring consistent accounting of all derivative (i.e. embedded and standalone) instruments, we support restrictions on reclassifications bearing in mind that the accounting rules related to embedded derivatives affect a wide array of host contracts. These host contracts include debt and equity instruments, leases, insurance contracts, purchase and sale contracts, service agreements (royalty, franchises, advertising etc) and financing arrangements. The accounting rules affect both financial and non-financial institutions.

DUE PROCESS

Across different financial reporting stakeholders, there seems to be unanimity that IAS 39 needs to be improved. This is evident from the comments provided towards the recently published discussion paper on '*Reducing Complexity for Financial Instruments*'. We reiterate the position we have taken in other comment letters[4] that a holistic approach to improving the accounting for and financial reporting of financial instruments is desirable.

The credit crisis has resulted in increased pressures from regulators and financial institutions to be responsive to their concerns. Concurrently, the board seems to be adopting what seems like a jumble of ad-hoc changes. One downside of this patchwork approach is that it necessitates multiple interim corrective measures whenever unanticipated consequences, due to a rushed due process, arise. We therefore urge the board to focus on dealing with financial instrument accounting in its entirety under a single project. Such an approach would be efficient from a project management perspective and would minimise the implementation burden for both preparers and users of financial statements.

JOINT APPROACH WITH FASB

From the exposure draft it is not clear whether the IASB intends to work in conjunction with FASB to ensure consistency in the accounting for embedded derivatives. We support the principle of separation of embedded derivatives as required by all IAS 39. FASB SFAS 133, paragraph 14B allows exceptions, for example, in relation to fully funded synthetic CDO instruments.

There is need for both boards to look at this issue on a joint basis. The rationale for working together is strengthened by the argument put forward by some stakeholders that they were seeking a level playing field with the more flexible separation requirements under US GAAP, SFAS 133, paragraph 14B (see appendix for communication excerpt from European Commission). FASB has recently issued a clarification paper on its requirements. Nonetheless, financial statements will be more comparable if a common approach is adopted.

SPECIFIC COMMENTS

RECLASSIFICATION: ASSESSMENT FOR SEPARATION

The amendments require the assessment and separation of embedded derivatives during the reclassification of hybrid instruments. The assessment is to be made based on the circumstances that prevailed at the initiation of the hybrid instrument contract. The underpinning rationale, as outlined in paragraph BC6, is to prevent structuring opportunities.

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[4] 19th September 2008 Comment letter on reducing complexity of financial instruments

As a working principle, this would appear favourable as it is an anti-abuse provision, and it would likely ensure that once an item has been identified as an embedded derivative it would remain under that category during the holding life of the hybrid instrument. Nonetheless, there is conceptual inconsistency in a separation assessment approach that is based only on the circumstances that existed at the inception of the contract. A reflection of current economic reality ought to be based on circumstances prevailing at the reporting date. This is especially important for long tenor instruments, for example, instruments initiated 10 years ago.

INABILITY TO MEASURE EMBEDDED DERIVATIVES

We support the proposal to have the hybrid instrument remain under the fair value through the profit and loss category when it is difficult to determine the fair value of the embedded derivative. This approach will ensure greater reporting transparency of hybrid instruments.

EFFECTIVE DATE AND TRANSITION

The proposed effective date is 15th December 2008. This date appears reasonable as it is meant to correct the consequences of the contentious October 2008 amendments. However, these amendments alongside those made in the October 2008, should be applied to the previous reporting period to facilitate comparability with the prior period.

CLOSING REMARKS

If you, other Board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org, or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht	*/s/ Gerald I. White*
Kurt N. Schacht, CFA Managing Director Council	Gerald I. White, CFA Chair, Corporate Disclosure Policy

cc: Corporate Disclosure Policy Council

APPENDIX:
PRIMER ON EMBEDDED DERIVATIVES ACCOUNTING AND WHY IT MATTERS IN THE CURRENT CREDIT CRISIS

BACKGROUND

Why is the accounting for embedded derivatives relevant for investors?

The accounting for embedded derivatives (see definition below) has arisen as one of the possible means of curtailing the current application of fair value for financial instruments.

In October 2008, in response to exceptional circumstances, the IASB amended accounting standards relating to the reclassification of financial instruments. The amendments made by the IASB without due process and under political pressure allow for the reclassification of financial instruments out of the fair value through profit and loss category into the held to maturity category. Classification affects the choice of whether to account for a financial instrument on a fair value or amortised cost basis.

Issuing that amendment without normal due process carried the risk of unintended consequences, and on 22 December, 2008 the IASB proposed to clarify the application of its October 2008 amendment to embedded derivatives.

The accounting for embedded derivatives is specified under the financial instrument recognition and measurement standards discussed in FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" under US Generally Accepted Accounting Principles (US GAAP) and IAS 39, Financial Instruments: Recognition and Measurement under International Financial Reporting Standards (IFRS). There are differences in approach between IASB standards and US GAAP. IFRS requires all embedded derivatives to be accounted for on a fair value basis, but US GAAP permits exceptions.

The issue of embedded derivatives accounting was raised by the European commission in relation to the accounting for synthetic CDO instruments as they sought parity with US GAAP. The issue was further raised by auditors and preparers because of the lack of clarity contained in the implementation guidance standard – International Financial Reporting Interpretations Committee No. 9 (IFRIC 9). The contention made was that preparers were not sure whether the changes in reclassification rules implied a change in the accounting for embedded derivatives.

In the meeting of the Financial Crisis Advisory Council to the IASB and FASB, held on 20th January 2009 in London, embedded derivative accounting was identified as one of the key issues being addressed by the IASB. The full list of other issues identified included:

- The definition of fair value under IFRS
- Financial instrument disclosure
- Off-balance sheet accounting (consolidation, the accounting for structured vehicles and de-recognition)
- Rules of reclassification of financial instruments
- Embedded derivatives

- Financial instrument impairment rules

As we still dwell in a mixed measurement attribute world in accounting and are likely to do so in the near future, the debate on fair value extends beyond the question of whether fair value is the best measurement basis. Both Boards believe it is. The contemporary questions extend to and require commentary and policy formulation at an instrument specific level. The list of key priority items reinforces this latter point.

Why do these rules matter for investors?
Understanding the classification and accounting for financial instruments matters for investors because:

- Similar to the rules for reclassification of financial instruments, these rules can influence period to period, cross country and cross sectional comparability of financial reports. Preliminary data from financial institution disclosure in the third quarter of 2008 illustrates how the change in reclassification rules may cause reduced comparability and potentially misleading indicators of performance.[5]

- The prevailing accounting rules can influence the volume of instruments issued. In understanding the underlying economics of reporting entities, it is important to unravel the extent to which accounting rules have influenced economic choices (e.g. risk transfer choices) due to the anticipated effect on earnings volatility. Examples of how accounting influences instrument issuance are provided in a 2007 Bank of America report[6] on credit derivatives. The report illustrates how the issuance of synthetic CDOs varied in accordance with the flexibility of the rules on whether to report such instruments at fair value.

EMBEDDED DERIVATIVE ACCOUNTING DESCRIPTION[7]

What is an embedded derivative?

A derivative may be embedded in a financial instrument in combination with a host contract. A host contract is the part of the combined contract other than the embedded derivative (the contract in which the

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[5] In October 2008 the European Union endorsed amendments to IAS 39 and IFRS 7, 'Reclassification of Financial Assets', which permit the reclassification of trading assets and assets available for sale in cases involving a clear change of management intent. In accordance with these amendments, Deutsche Bank reclassified certain assets, for which no active market existed in the third quarter and which management intends to hold for the foreseeable future, out of trading assets and assets available for sale, and into loans. If these reclassifications had not been made, the income statement for the quarter would have included negative fair value movements relating to the reclassified assets of EUR 845 million. Additionally, incremental net interest margin relating to reclassified assets was EUR 53 million for the quarter.(See http://www.db.com/presse/)

[6] Credit Default Swap Primer, Glen Taksler, February 28, 2008, Bank of America Debt Research Credit Strategy, Pg 10

[7] Definition and description of accounting is Adopted from Ian Hague: Applying International Financial Reporting Standards: Financial Instruments

derivative is embedded). The combination of a host contract and an embedded derivative is known as a hybrid contract.

How do you account for embedded derivative?
As a general principle derivative instruments are accounted for on a fair value basis under US GAAP and IFRS. The same principle is applied to embedded derivatives; under US GAAP and IFRS, an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument if all of the following criteria are met:

- *If the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract?*
- *If the hybrid contract is not accounted for at fair value with changes in fair value recorded in profit or loss (as defined under IFRS) or earnings (as defined by US GAAP); and*
- *If a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.*

An embedded derivative would be considered closely related to its host contract if its cash flows on a stand-alone basis vary in a manner similar to the cash flows of the combined contract. This is inevitably a subjective determination since the accounting literature cannot contemplate every potential financial instrument.

What are examples of embedded derivatives?
- A commodity indexed note in which the principal or interest payments are based on the commodity price
- Debt with an option for repayment in fixed amount of foreign currency
- Synthetic CDO (i.e. purchase treasury bonds and enter credit derivative contracts). This allows firms to mimic the risk profile of cash CDOs

Excerpt from EC Communication (The three issues- Annex) including Embedded Derivatives *As we have just said, we think differences between the requirements in IFRS and in US GAAP on accounting for financial instruments are undesirable, particularly at the current time. Such differences can bestow competitive advantage on financial institutions in one jurisdiction over another, and such advantages can have significant implications at the current time for the financial institutions concerned—and therefore also for financial stability in each jurisdiction and for the financial system at large.*

One difference that is a particular concern in Europe arises from paragraph 14B of FAS 133 (inserted into FAS 133 by FAS 155). That paragraph states that changes in cash flows attributable to changes in the creditworthiness of an interest resulting from securitized financial assets and liabilities (including derivative contracts) that represent the assets or liabilities that are held by the issuing entity shall not be considered to be an embedded derivative. Thus, some of these securitized financial assets, generally referred to as "synthetic CDOs",could be viewed as having the economic substance of a credit default swap collateralized by a risk-free asset. As a result of the substance-over-form principle, there seem to be a consensus among European accountants that the credit-default swap component should be bifurcated because it appears not to be clearly and closely linked with the risk-free asset. As a result, the credit risk component of synthetic CDOs in US

securitisations would not need to be recognised separately. If the synthetic CDO is classified—or reclassified—in an accounting category measured at amortised cost, its credit risk component would not need to be measured at fair value. It would be submitted only to credit risk impairment tests.

We understand that the generally agreed interpretation of IAS 39 is that those same structures are required by IAS 39 to be treated as involving an embedded derivative. As a consequence, European companies using IFRS have to recognise these embedded derivatives separately and measure them at fair value in any case, even if the host instrument is classified—or reclassified—in an accounting category measured at amortised cost. In the current economic environment, fair value changes on these embedded derivatives result in significant losses to be recognised in the income statement.

This situation may create several differences in the accounting treatment of the related CDOs. The whole instrument could be recognised as available-for-sale or held-to-maturity (or loans-and-receivables if not quoted on an active market) in US GAAP whereas under IFRS the embedded derivative would always be recognised in the fair value through profit or loss category. Moreover, if the embedded derivative cannot be separated or measured separately, the whole instrument must be at fair value. It may also prevent reclassification at least of the embedded derivative and even of the whole instrument if the derivative cannot be separated. Under US GAAP the whole instrument may be eligible for reclassification.

This difference in the requirements not only has an effect on the accounting but also seems to be having an effect on behaviour because the IAS 39 requirements are seen as a disincentive to hold such securities.

We recognise that there is always a danger of focusing on paragraphs in isolation and claiming that a difference exists when, if one looked at the set of requirements in their entirety, it would become apparent that the difference is not substantive. In this case, for example, it is important to look at how the different impairment requirements would apply to such instruments under current market conditions. It is also necessary to bear in mind that at least some of the structures falling within the scope of FAS 133.14B will, under both US GAAP and IFRS, be deemed to have other derivatives embedded in them and that too might have the effect of bringing the accounting closer together. However, this is difficult to assess, especially in the current economic context. We intend to look into this further, but in the mean time is of the essence so we encourage the IASB to eliminate any competitive advantage that exists.

We therefore think action needs to be taken to eliminate the difference in accounting. The Commission appreciates the initiative by the IASB and the FASB to work on ways to make impairment tests consistent in US GAAP and IFRS. In the same way, it may also be needed to address differences in the accounting treatment applied to embedded derivatives. We think there are probably three main issues that need to be analysed:

1) Whether under IAS 39 "synthetic" CDOs include a separate embedded derivative,

2) If answer to 1) is no, how to deal with CDOs designated as at fair value through profit or loss because they were suppose to include an embedded derivative.

3) If answer to 1) is yes, whether reclassification of "synthetic" CDO out of the fair value option category should be allowed, how to deal with the embedded derivative in this case.